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Supreme Court, U.S.
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No. 02-

Supreme Court of the United States

SHELDON KRANTZ,

Petitioner,

v.

PRUDENTIAL INVESTMENTS FUND MANAGEMENT LLC and PRUDENTIAL INVESTMENT MANAGEMENT SERVICES LLC,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

JOEL C. FEFFER
Counsel of Record
DANIELLA QUITT
WECHSLER HARWOOD LLP
Attorneys for Petitioner
488 Madison Avenue
Eighth Floor
New York, NY 10022
(212) 935-7400

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QUESTION PRESENTED

Whether the United States Court of Appeals for the Third Circuit, in direct contravention of this Court's holding in *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506 (2002), erred in adopting a heightened pleading standard which substantially limits access to Section 36(b) of the Investment Company Act of 1940, the only express private right of action provided to mutual fund investors, by requiring that complaints plead evidence not publicly available.

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Petitioner respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The opinion of the District Court (10a - 22a) is officially reported at 77 F. Supp. 2d 559. The opinion of the United States Court of Appeals for the Third Circuit (1a - 9a) is officially reported at 305 F.3d 140.

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was entered on August 30, 2002. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTE AND RULE INVOLVED

The text of Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b), and the text of the relevant provisions of Fed. R. Civ. P. 8(a), 28 U.S.C. Rule 8(a), are reproduced beginning at App., *infra*, 23a.

STATEMENT OF THE CASE

Petitioner, a shareholder of the Prudential Jennison Growth Fund (the "Fund"), commenced this action seeking relief under Section 36(b) of the Investment Company Act of 1940 (the "ICA"), 15 U.S.C. § 80a-35(b). Defendants are the Fund's investment adviser and principal underwriter. The jurisdiction of the District Court was invoked under ICA Sections 36(b)(5) and 44, 15 U.S.C. §§ 80a-35(b)(5) and 80a-43, as well as 28 U.S.C. § 1331 (general Federal question jurisdiction).

As described by this Court,

> Mutual funds pool the investment assets of individual shareholders. Such funds typically are organized and underwritten by the same firm that serves as the company's "investment adviser." The ICA seeks to arrest the potential conflicts of interest inherent in such an arrangement . . . . The [ICA] requires, *inter alia*, that at least 40% of the investment company's directors be financially independent of the investment adviser . . . and that the dealings of the adviser with the [Fund] measure up to a fiduciary standard, the breach of which gives rise to a cause of action by . . . an individual shareholder on the [Fund's] behalf, [15 U.S.C.] § 80a-35(b).

Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 93 (1991).

The thrust of petitioner's claim is that because the Fund's "independent" directors serve on boards of defendants' multiple investment companies, in exchange for significant compensation, they have neither the time nor the inclination to monitor defendants with the aggressiveness and diligence necessary to fulfill what this Court has described as their legislative mandate to act as "watchdogs" for public investors. *Burks v. Lasker*, 441 U.S. 471, 485 (1979). In other words, they merely rubber stamp defendants' decisions, becoming, in effect, "controlled" by defendants within the meaning of the ICA.

Among the facts and reasonable inferences relevant to the issue of control set forth in the complaint are the following:

- Three of the 11 members of the Fund's board of directors are acknowledged affiliates of defendants.

- The remaining eight directors serve on between 15 and 38 boards of the funds managed by defendants or their affiliates (the "Fund Complex") and receive between $45,000 and $135,000 annually therefrom.

- The "independent" directors' compensation is greater than the collective investment these individuals have in each of the funds within the Fund Complex.

- Defendants' practice of having "independent" directors serve on the boards of between 15 and 38 different funds flies in the face of an explicit warning by industry counsel about "potential conflicts that accompany service on a number of boards." Task Force - A.B.A. Sec. Bus. L., *Fund Director's Guidebook*, 52 The Bus. Law. 229, 240 (1996).

- The number of boards upon which the Fund's "independent" directors serve vastly exceeds the maximum number of directorships recommended by the prestigious, nonpartisan National Association of Corporate Directors.

- The complaint cites a study that examined the relationship between fees and multiple directorships and which "revealed a disturbing pattern: *The more money trustees get, the more shareholders pay in expenses*. This unexpected link between trustees' salaries and fund-family expenses raises serious questions about the role independent trustees play in protecting shareholders." Michael Mulvihill, *A Question of Trust* (Morningstar, Inc. 1996) (emphasis added). In addition, the complaint quotes John Bogle,

founder of Vanguard Group, the second largest mutual fund complex in the United States, to the effect that "independent directors" are sinecures rather than watchdogs.

- From the foregoing facts, which include (i) the number of boards within the Fund Complex upon which each "independent" director serves, (ii) the remuneration received by each "independent" director, (iii) that industry counsel caution against the increased workloads and potential conflicts resulting from multiple directorships, (iv) that the number of directorships held vastly exceeds the outer limits recommended by the prestigious National Association of Corporate Directors, (v) the empirical relationship between highly compensated directors and highly compensated investment advisers, and (vi) the criticism leveled at "independent" directors by industry insider John Bogle, petitioner draws the following reasonable inferences:

> The excessive number of boards upon which the Fund's directors serve and concomitant assembly-line, truncated board meetings, effectively prevents them from being able to fulfill their statutory role as watchdogs for the public investors. Rather, the Fund's board is effectively controlled by [defendants] and merely rubber-stamps proposals of defendants. As a result, each of the directors is an "interested person" within the meaning of ICA Sections 2(a)(3),

> 2(a)(19)(A)(i), and 2(a)(19)(B)(i), 15 U.S.C. §§ 80a-2(a)(3), 80a-2(a)(19)(A)(i), and 80a-2(a)(19)(B)(i).

For the Court's convenience, the operative complaint is reproduced at App., *infra*, beginning at 27a.

In granting defendants' Fed. R. Civ. P. 12(b)(6) motion to dismiss for failure to state a claim upon which relief may be granted, the District Court found that the complaint did not meet a "heightened" pleading standard. (15a.) The District Court also denied petitioner leave to amend. (10a.) The Court of Appeals affirmed, relying entirely on a decision of the Court of Appeals for the Fourth Circuit. Petitioner does not seek review of the Court of Appeals' affirmance of the District Court's denial of leave to amend.

REASONS FOR GRANTING THE WRIT

I. The Court Of Appeals' Affirmance Directly Contravenes This Court's Holding In *Swierkiewicz v. Sorema N.A.*

The crux of the District Court's decision is the following:

> Plaintiff's burden to plead facts that state a claim, rather than mere legal conclusions, is heightened here by the statutory presumption against his claim. As set forth in defendants' moving brief, the ICA expressly provides that "[a] natural person shall be presumed *not* to be a controlled person within the meaning of [the Act]." 15 U.S.C. § 80a-

> 2(a)(9) (emphasis added). "The burden of overturning the presumption against control of a natural person is not one that will be lightly assumed or easily carried to success." *Acampora v. Birkland*, 220 F. Supp. 527, 543 (D. Colo. 1963) (*quoting In the Matter of Fundamental Investors, Inc.*, Investment Co. Act. Rel. #3596).

(15a - 16a.) The District Court failed to address either of the following arguments advanced by petitioner: (1) the 15 U.S.C. § 80a-2(a)(9) presumption is an evidentiary presumption, not a pleading burden, as the very next sentence of the statute begins with the phrase, "[a]ny such presumption may be rebutted by evidence"; and (2) *Acampora v. Birkland*, 220 F. Supp. 527 (D. Colo. 1963), is a post-trial decision, irrelevant to pleading issues. -

On appeal, petitioner urged the Court of Appeals that this Court's decision in *Swierkiewicz v. Sorema N.A.* is controlling. The Court of Appeals did not follow *Swierkiewicz*. The Court of Appeals did not distinguish *Swierkiewicz*. The Court of Appeals did not even mention *Swierkiewicz*. Instead, the Court of Appeals elected to follow the Fourth Circuit's "*ratio decidendi*" (6a) in *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321 (4th Cir. 2001), without noting this Court's intervening decision in *Swierkiewicz*.

In *Migdal*, the Fourth Circuit held, in language directly contrary to the holding in *Swierkiewicz*, that ICA Section 2(a)(9) "expressly creates a presumption against control," which "presumption, however, may be rebutted by 'evidence.'" 248 F.3d at 329-30. The Fourth Circuit then went on to examine the complaint for "evidence" of control, concluding as follows:

> There is a presumption under the ICA that natural persons are disinterested . . . which plaintiffs' *evidence* simply fails to counteract. Plaintiffs have thus failed to state a claim that the funds' disinterested directors are in fact interested.

Id. at 331 (emphasis added). Corporate boards do not transact their affairs in public. It surely can be no surprise that on a pleading motion, and without being afforded discovery, the plaintiff in *Migdal* was unable to present "evidence" sufficient to overcome the statutory presumption that natural persons are not "controlled."

The litigation posture in *Swierkiewicz* is similar to the instant action. The Second Circuit "require[d] a plaintiff in an employment discrimination complaint to allege facts constituting a prima facie case of discrimination under the framework" established in an earlier decision of this Court. 534 U.S. at 509. The plaintiff did not do so. The district court dismissed the complaint and the Second Circuit affirmed the dismissal. This Court reversed, holding that the Second Circuit's conversion of an evidentiary standard into a pleading requirement was improper. *Id.* at 512.

In language equally applicable here, this Court held that:

> imposing the Court of Appeals' heightened pleading standard in employment discrimination cases conflicts with Federal Rule of Civil Procedure 8(a)(2), which provides that a complaint must include only "a short and plain statement of the claim showing that the pleader is entitled to relief." Such a statement must simply "give the defendant fair notice of

> what the plaintiff's claim is and the grounds upon which it rests." This simplified notice pleading standard relies on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims. "The provisions for discovery are so flexible and the provisions for pretrial procedure and summary judgment so effective, that attempted surprise in federal practice is aborted very easily, synthetic issues detected, and the gravamen of the dispute brought frankly into the open for the inspection of the court."
>
> Rule 8(a)'s simplified pleading standard applies to all civil actions, with limited exceptions. Rule 9(b), for example, provides for greater particularity in all averments of fraud or mistake. This Court, however, has declined to extend such exceptions to other contexts.

Id. at 512-13 (citations and footnote omitted).

As described, *supra*, the complaint not only provides notice to defendants of petitioner's claim of lack of independence (defendants do not contend otherwise) but includes substantial factual allegations and reasonable inferences supporting such claim. Among such allegations are those dealing with board members' substantial compensation, their purporting to act as "watchdogs" for up to 38 separate registered investment companies, their ignoring cautionary warnings from industry counsel about multiple directorships, and their ignoring the non-partisan National Association of Corporate Directors' recommendations on multiple directorships. There can be little doubt that defendants are on

notice of the alleged breaches of fiduciary duty. If defendants think otherwise, the proper response is for them to "move for a more definite statement under Rule 12(e) . . . ." *Id.* at 514. *See also In re Kauffman Mut. Fund Actions*, 479 F.2d 257, 263 n.4 (1st Cir. 1973) ("[t]he presumption supplied by [ICA Section 2(a)(9)] . . . whatever may be its effect at a trial, could not be used to contradict the complaint"). There also can be little doubt that the complaint (27a - 39a) contains far more detail than the forms of complaints set forth in the Federal Rules of Civil Procedure Forms. *Swierkiewicz*, 534 U.S. at 513 n.4.

Accordingly, the Court of Appeals' failure to mention, let alone apply, either the holding or reasoning in *Swierkiewicz* warrants a grant of certiorari.

II. The Court of Appeals' Decision Creates An Unreasonable Barrier To ICA Section 36(b)

At December 31, 2001, "[a]n estimated 93.3 million individuals in 54.8 million U.S. households" owned 76% of the almost $7 trillion of mutual fund assets. Investment Company Institute, *2002 Mutual Fund Fact Book* 37 (42d ed. 2002). If a mutual fund's independent directors fail in their role as "watchdogs," the ICA provides only one express private right of action for these 93.3 million individuals – Section 36(b), 15 U.S.C. § 80a-35(b). Creating artificial barriers to investors' recourse to Section 36(b) results in "denial of a private right of action to those for whose ultimate protection the legislation is intended [and] leaves legislation highly publicized as in the public interest in fact sadly wanting, and even delusive, to that end." *Goldstein v. Groesbeck*, 142 F.2d 422, 427 (2d Cir. 1944).

Neither the Third Circuit here, nor the Fourth Circuit in *Migdal*, provide any guidance as to what must be pled in order

to satisfy the heightened pleading standard for "control." The District Court relied on *Verkouteren v. Blackrock Fin. Mgmt., Inc.*, 37 F. Supp. 2d 256 (S.D.N.Y. 1999). *Verkouteren* demonstrates why a heightened pleading standard on the issue of "control" is the equivalent of a death knell. In *Verkouteren*, the court reviewed the complaint for indicia of control, including "social relations," "the amount of time spent by directors at meetings," "participation in recommending, evaluating, and terminating policies," "independent knowledge of corporate affairs," and "actual domination and operation" (37 F. Supp. 2d at 261), all matters about which a plaintiff can be expected to have little, if any knowledge, in the absence of discovery. Thus, the practical result of a heightened pleading standard is to preclude an investment company shareholder from looking behind the facade of a self-proclaimed independent director.

In 1940, when the ICA was enacted, there was a total of 68 mutual funds. Investment Company Institute, *2002 Mutual Fund Fact Book* 61 (42d ed. 2002). In 1970, when Section 36(b) was added to the ICA, there was a total of 361 mutual funds. *Id.* Today, largely as a result of marketing strategies employed by the asset management industry, there are well over 8,000 mutual funds. *Id.* In recent years, the industry has witnessed the development of huge mutual fund complexes. The 25 largest mutual fund complexes managed 74% of the almost $7 trillion of mutual fund assets at December 31, 2001. *Id.* at 35.

The asset management industry finds it administratively convenient to appoint the same individuals to the boards of all or a large segment of a mutual fund complex, resulting in management and oversight on a fund complex-by-fund complex basis. However, the ICA requires management and oversight on a fund-by-fund basis. *See, e.g.*, ICA Sections 10(a), 15 U.S.C. § 80a-10(a) ("No registered investment

company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company."); 15(c), 15 U.S.C. § 80a-15(c) ("[I]t shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company . . . ."); and 36(b), 15 U.S.C. § 80a-35(b) ("[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation . . . .").

Decisions such as those by the Third Circuit here and the Fourth Circuit in *Migdal*, recognize the existence of huge mutual fund complexes and the practice of appointing the same individuals to the boards of all or many of the funds within a fund complex. Such decisions, however, ignore the ICA's statutory scheme and dilute the protections afforded investors therein. It is not the role of the judiciary to modify laws by sacrificing investor protection in order to sanction current industry practices, but to apply unambiguous laws as written. *Barnhart v. Sigmon Coal Co.*, 534 U.S. 438, 460-61 (2002); *Harris Trust & Sav. Bank v. Salomon Smith Barney, Inc.*, 530 U.S. 238, 254 (2000).

A different panel of the Third Circuit, quoting Section 36(b)'s legislative history, noted that the purpose of ICA Section 36(b) is to provide a realistic "mechanism by which the fairness of management contracts could be tested in court." *Green v. Fund Asset Mgmt., L.P.*, 245 F.3d 214, 225 (3d Cir. 2001), *aff'd*, 286 F.3d 682 (3d Cir.), *cert. denied*, 123 S. Ct. 116 (2002). The decision of the Court of Appeals in this action sanctions an unrealistically high pleading threshold which effectively prevents investors from testing "the fairness of management contracts."

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

Joel C. Feffer*
Daniella Quitt
Wechsler Harwood LLP
488 Madison Avenue
New York, New York 10022
(212) 935-7400

Counsel of Record